

VZCZCXRO4654
RR RUEHDBU RUEHLN RUEHVK RUEHYG
DE RUEHKB #0147/01 0321030
ZNR UUUUU ZZH
R 011030Z FEB 07
FM AMEMBASSY BAKU
TO RUEHC/SECSTATE WASHDC 2322
INFO RUCNCIS/CIS COLLECTIVE
RUEHAK/AMEMBASSY ANKARA 1976
RUCPDOG/DEPT OF COMMERCE WASHDC
RHEBAAA/DEPT OF ENERGY WASHDC
RUEATRS/DEPT OF TREASURY WASHDC

UNCLAS SECTION 01 OF 02 BAKU 000147

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SENSITIVE

DEPT FOR EB A/S SULLIVAN

E.O. 12958: N/A

TAGS: [ECON](#) [PREL](#) [PGOV](#) [EFIN](#) [EPET](#) [ENRG](#) [AJ](#)

SUBJECT: ECONOMIC PARTNERSHIP COMMISSION SCENESETTER FOR EB
A/S SULLIVAN'S VISIT TO AZERBAIJAN

REF: (A) 06 BAKU 1721 (B) BAKU 131 (C) BAKU 89

SENSITIVE BUT UNCLASSIFIED - NOT FOR INTERNET DISTRIBUTION -
HANDLE ACCORDINGLY

¶1. (SBU) The inaugural Economic Partnership Commission comes at a critical time as we look to elevate the U.S.-Azerbaijan bilateral economic dialogue. Azerbaijan's rapid economic growth, the fastest in the world, and its expected USD 250 billion in energy revenues over the next decade, highlight the need for continued U.S. engagement to ensure Azerbaijan's successful sustainable economic development. The Government of Azerbaijan (GOAJ), led by President Aliyev and his economic team of Finance Minister Sharifov, Economic Development Minister Babayev, National Bank Chairman Rustamov, and Oil Fund Executive Director Movsumov, is keen to secure the correct path for sustainable long-term economic development.

¶2. (SBU) Drawing upon the President Aliyev's long-term vision for sustainable development and sound use of Azerbaijan's energy revenue (ref a), the EPC could be a useful tool to help shape Azerbaijan's transition from a struggling post-Soviet state to a democratic, market-oriented regional leader that is a strong partner in Euro-Atlantic institutions. Key objectives for the EPC include instilling with the GOAJ the need for a stable macroeconomic environment, stressing the importance of an open business environment, highlighting the positives of World Trade Organization membership, and encouraging more GOAJ co-financing of U.S. assistance projects. In all of these areas, we would like to achieve concrete results and agree with the GOAJ on strategic objectives for the coming year.

ECONOMIC CHALLENGES

¶3. (SBU) The GOAJ faces many economic and political challenges as it attempts to utilize and manage efficiently its energy wealth. With the fastest growing economy in the world, Azerbaijan stands ready to receive more than USD 250 billion in oil and natural gas revenues over the next decade and a half. The "Tsunami of money" begins in 2009 when the GOAJ should receive approximately USD 20 billion in energy revenues. The GOAJ's ability to absorb and appropriately manage this massive influx of money is limited by a fractured economic decision-making process, wide-spread corruption in all sectors, an opaque and monopolized business climate, weak rule of law, and a lack human capacity. While the GOAJ has taken some initiative to improve the economic situation, other areas, such as its efforts to combat corruption and

implement rule of law, have fallen well short.

MACROECONOMIC ENVIRONMENT

¶4. (SBU) In 2005 and 2006 Azerbaijan experienced rapid economic growth, with GDP growth exceeding more than 30 percent in both years. Local economic and financial experts expect GDP growth to exceed 30 percent again in 2007. The main engine behind the GDP growth remains the vibrant energy sector (energy scenesetter septel). Inflation remains relatively tame, although the recent fuel price and utility tariff increases in January (ref b and c) likely will raise inflation levels close to 20 percent for 2007. In 2006, the GOAJ tightly controlled the appreciation of the Azerbaijani manat, holding down prices at the expense of higher inflation. It is likely that the National Bank will resume its anti-inflation strategy in 2007, however, and allow the national currency to appreciate against the U.S. dollar.

BUSINESS OPERATING ENVIRONMENT

¶5. (SBU) Operating a legitimate business in Azerbaijan -- outside the transparent legal framework of the energy sector's Production Sharing Agreements -- is a challenging endeavor within a system stacked in favor of illegal operations. Many legal businesses in the non-energy sectors face official bureaucracy, lack of capacity, rule of law problems, and corruption that cloud the investment climate and create a difficult environment in which to do business. Days before your visit to Baku, the GOAJ plans to announce new measures in order to improve Azerbaijan's World Bank/IFC "Doing Business" rating. This first positive step needs to

BAKU 00000147 002 OF 002

be followed by a series of measures that ensure the effective development of Azerbaijan's non-oil sector, including agriculture.

¶6. (SBU) The agricultural sector continues to contract as more arable land remains untilled and rural agricultural workers come to the capital Baku looking for work. While the GOAJ, in coordination with the international donor community, has attempted to spur economic growth in the rural areas, positive development has been limited. In the long-term, the agricultural sector will be key to Azerbaijan's economic and political stability. Unlike its Caspian Sea neighbor Kazakhstan, Azerbaijan's proven energy resources will most likely be depleted shortly after 2030 and the country urgently needs to develop the non-oil sector to ensure future growth.

¶7. (SBU) A fractured system of economic decision-making further hinders Azerbaijan's ability to manage the current transition. The GOAJ's budgetary, fiscal and monetary policy decision-making has not always included all branches of the government. Finance Minister Sharifov (appointed in April 2006) appears to be making a concerted effort to organize economic policy to ensure efficient management of the country's resources. The U.S. needs to support GOAJ efforts to reform the economic decision-making processes and transform Azerbaijan into an economically stable democracy.

¶8. (SBU) Sharifov, along with Economic Development Minister Babayev, the State Oil Fund Executive Director and the National Bank Chairman, has been active in utilizing the recently implemented macroeconomic modeling unit set up at the Oil Fund to run macroeconomic scenarios based upon government spending and inflation. President Aliyev's economic team, however, faces an economy controlled by large state-owned enterprises and monopolies, effectively suffocating entrepreneurial growth. The banking sector, for example, is vibrant and dynamic but its long-term growth is stunted by the two large state-owned banks (International Bank of Azerbaijan and Kapital Bank) which control more than

50 percent of the retail and commercial banking sectors.

GOAJ COMMITTED BUT NEEDS U.S. ADVICE

¶9. (SBU) Azerbaijan is interested in hearing U.S. advice on how best to manage its transition and long-term sustainable development. The EPC is a forum to present USG expertise and technical knowledge that will resonate with senior GOAJ officials. As in many post-Soviet countries, Azerbaijan lacks the experience necessary to manage its energy wealth and rapid growth. The USG, within the EPC framework, will have the opportunity to offer its collective thoughts and counsel on managing the macroeconomic environment, how to improve the business operating environment to spur more foreign direct investment and stress the importance of combating corruption.

¶10. (SBU) In addition, with falling U.S. assistance funds, the U.S. and GOAJ will need to implement a co-financing plan which enables continued U.S. technical assistance over the long term. While some of the U.S. messages may not resonate immediately within in the GOAJ, it is in the long-term U.S. interest that Azerbaijan take the stable and successful path towards economic, social and political reform. The robust U.S. assistance strategy with Azerbaijan remains an important part of the U.S.-Azerbaijan bilateral relationship.

¶11. (U) The participation of a broad USG interagency delegation in the inaugural EPC signals to Azerbaijan the seriousness of U.S. economic commitment to successful development and provides an excellent opportunity to advance the critical reform agenda needed for a stable Azerbaijan. Embassy Baku looks forward to ensuring the EPC is a success.
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